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**THE DIRECTOR OF CENTRAL INTELLIGENCE**

WASHINGTON, D.C. 20505

NIC #01787-84

19 March 1984

**National Intelligence Council**

*HH. ER 84-1216*

MEMORANDUM FOR: Director of Central Intelligence  
Deputy Director of Central Intelligence

FROM: Maurice C. Ernst  
NIO for Economics

SUBJECT: NSC Meeting on Iran-Iraq Energy Issues

1. The purpose of the NSC meeting is to establish some basic guidelines on which to base US foreign policy and economic actions in the event of a Persian Gulf supply interruption. The main issues for decision concern:

- o How should the US approach triggering the IEP sharing system in the event of a severe disruption?
- o To what degree should we seek consultation or coordination with our Allies on stock draws?
- o Should the US support coordinated international action to influence this market?

On each issue the options range from little or no US Government action (letting the market do the job) to various forms of joint action and coordination with other nations.

2. In our opinion, the issues on which the NSC is asked to focus basically address how best to minimize the impact of a given disruption on the world oil market. The Administration's main objective is to avoid a recurrence of the enormous price increases that occurred in 1979 in response to a very small world oil shortage. Although this is certainly an important objective, even more important are two types of policy action which are only briefly mentioned in the attached papers. These are:

- o What the US can do to prevent a supply disruption in the first place; and
- o What actions the US can take to minimize the size of any shortfall and its duration.

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3. The NSC study does not systematically review US diplomatic, economic, and military initiatives aimed at preventing an Iraqi escalation of the war which would threaten Iranian oil supplies, or an Iranian response which could threaten Gulf oil supplies. Up to now, both the Iraqis and the Iranians have been cautious in their actions, if not in their statements. Iraq will probably attack Iranian oil exports if its military situation looks desperate. But so far it is not, and US support for any Iraqi oil export pipelines, as well as continued large-scale Saudi assistance to Iraq, may prevent the worst from happening. These questions are being addressed in the CCPG, but we have not seen any paper.

4. Just as important is US deployment of military forces in the area, both to dissuade Iranian attacks and to deal with them if they occur. Working with the Saudis and Kuwaitis to increase oil industry security and to protect and rebuild facilities if an attack occurs obviously are also of critical importance, and little is said about the subject. DoD is examining these questions, but we are not aware that any interagency process is under way.

5. From an intelligence point of view, you may wish to make the following points:

- o Although Southern Gulf oil facilities are highly vulnerable to attack, the chances are small that the Iranians would succeed in damaging them so severely as to cause an extended reduction in Saudi and Kuwaiti exports once the smoke had cleared. Most of the critical facilities would have to be largely destroyed to cause a big oil supply shortfall.
- o Oil tankers in the Persian Gulf are highly vulnerable, however, to all kinds of attacks. Reopening the Straits would not make the Gulf safe for tankers. A large US naval presence might be required to do the job.
- o If there were major attacks against oil targets in the Southern Gulf, a great deal of uncertainty would prevail about the extent of the damage and its market impact. Initially oil prices would probably shoot up rapidly. The US Government could help calm the market by disseminating more accurate information. The Intelligence Community can help in this regard.
- o Since we believe that the great majority of possible disruptions would have a relatively small and short-lived impact on world oil supplies, it makes sense to focus policy reactions on calming the market and releasing stocks, rather than on triggering major coordinated policy moves, such as under the IEA. The IEA should be activated only if the disruption is known to be large and likely to continue for at least several months.

6. Attached are the following materials:

A. The NSC policy papers.

B. A memorandum from  "Energy Emergency Preparedness," with which I concur.

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C. The recent Interagency Assessment on the Iran-Iraq war and its effects.

D. An uncoordinated draft of the sections of the forthcoming SNIE World Oil Market Outlook: Key Political and Economic Dimensions dealing with interruptions of Persian Gulf oil supplies.

E. Selected IEEW articles and an IA from OGI International Oil Market Outlook: Midyear Assessment.

F. Some background statistics on the oil market.

  
Maurice C. Ernst

Attachments,  
As stated

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NIC #01787-84  
19 March 1984

SUBJECT: NSC Meeting on Iran-Iraq Energy Issues

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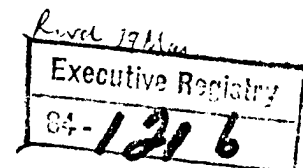
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WASHINGTON, D.C. 20506



March 16, 1984

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## MEMORANDUM FOR

MR. DONALD P. GREGG  
Assistant to the Vice President  
for National Security Affairs  
Office of the Vice President

MR. CHARLES HILL  
Executive Secretary  
Department of State

MR. CHRISTOPHER HICKS  
Executive Secretary  
Department of the Treasury

COLONEL JOHN STANFORD  
Executive Secretary  
Department of Defense

MR. BARRY ALLBRIGHT  
Director, Executive  
Secretariat  
Department of the Interior

MRS. HELEN ROBBINS  
Executive Assistant to the  
Secretary  
Department of Commerce

MR. WILLIAM VITALE  
Executive Secretary  
Department of Energy

MR. ALTON KEEL  
Associate Director for  
National Security and  
International Affairs  
Office of Management and Budget

[Redacted]  
Executive Secretary  
Central Intelligence Agency

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MR. WILLIAM NISKANEN  
Member  
President's Council of  
Economic Advisors

AMBASSADOR HARVEY FELDMAN  
Washington Representative for  
U.S. Ambassador to the United  
Nations

BRIG. GENERAL GEORGE A. JOULWAN  
Executive Assistant to the  
Chairman  
Joint Chiefs of Staff

SUBJECT: NSC Meeting on Iran-Iraq Energy Issues (S)

A National Security Council meeting has been scheduled for 2-3:00 p.m., Tuesday, March 20, 1984 in Room 208, Old Executive Office Building to discuss international energy issues and policy options arising out of the Iran-Iraq war. Attached are an agenda (Tab A) and background papers prepared by the Department of State (Tab B). (S)

*Robert M. Kimmitt*  
Robert M. Kimmitt  
Executive Secretary

Attachment

Tab A

Agenda

Tab B

Background Papers

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TAB A

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TAB B

Washington, D.C. 20520

March 12, 1984

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MEMORANDUM

TO: The National Security Council

FROM: Allen Wallis, Chairman *W*  
International Energy Security Group (IESG)

SUBJECT: Energy Emergency Preparedness -- International  
Energy Policy Issues Requiring Decision

The IESG has completed the first phase of its examination of policies of an international character that will enable us to deal effectively with an interruption of oil supplies from the Persian Gulf. Several issues for decision are set forth in this memorandum; others, dealing with the macroeconomic impact of an interruption, will be presented separately. The DOE-chaired Energy Response Group will submit to the Cabinet a separate set of options dealing with domestic aspects of preparing for an emergency.

NSDD-87 establishes that US policy in a disruption is to rely on the market, supplemented by withdrawal from the Strategic Petroleum Reserve (SPR). The US is committed in case of an energy emergency to consulting with its allies both bilaterally and in the International Energy Agency (IEA)\* and to fulfilling its obligations under the International Energy Plan (IEP).

\*The IEA is made up of the 21 leading industrial countries (all of the Western European countries except France and Finland, as well as Canada, US, Japan, Australia and New Zealand). Collectively the members account for about 70% of free world consumption. It was founded after the 1973 oil disruption, and the agreement includes a sharing plan which can be triggered if oil supplies to an individual member or to the IEA as a whole drop by 7% or more. Under the plan if triggered, each member country has agreed to limit its imports of oil. The US is committed to fulfilling its obligations under the plan, and to participation in its implementation if triggered. An information paper describing more fully the plan and the trigger is at Tab A.

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Because of the threat of major price and economic impacts we believe the NSC should address the international aspects of the policies set forth in NSDD-87. Descriptions of the options and the considerations involved are set forth in papers on each issue. This memorandum will briefly describe the current energy situation, the potential consequences of a disruption, and the issues for decision.

## A. The Current Energy Situation

- The international oil market today remains soft. Free world crude production in 1984 will likely range between 43 and 46 million barrels per day, of which Persian Gulf supplies would normally be about 30%; 20-22% of free world supply will transit the Strait of Hormuz.

	NET IMPORTS as % of Consumption	IMPORTS Through Strait of Hormuz	STOCKS (Million Barrels)	
			Commercial	Strategic
US	31-34%	2-4%	1055	387
OECD Europe	65-68%	18-22%	1000	145
Japan	100%	68-69%	339	79

- Japanese and European stocks are lower than ours measured in days of imports, but comparable to ours if measured in days of consumption. The figures for commercial stocks are overstated since they include amounts required to operate the refining and distribution system, and those amounts (40-60% of commercial stocks) are not available for use. There is currently surplus oil producing capacity of some 9-12 million barrels per day (MMBD) in the free world, 3 to 3.5 MMBD of it located outside the Persian Gulf area. Some 58% of the 7.7 MMBD currently exported through the Strait of Hormuz could be replaced through full utilization of existing alternative facilities.

## B. Potential for Disruption

- The conflict between Iran and Iraq presents the possibility of interruptions in supply. An escalation of the conflict could result in attacks on the major Iranian export terminal, Kharg Island. Iraqi success in preventing Iranian oil exports could lead to Iranian retaliation against other

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Gulf exporters or international shipping, and as a last resort, to attempts to close the Strait of Hormuz. An effort to close the Strait is unlikely, and the US has pledged to keep it open. More likely (though not yet probable) are attacks against other facilities or international shipping. The US, in cooperation with other Western countries, would assist Gulf countries in protecting their facilities and international shipping, if requested. There is a risk of terrorism, subversion, sabotage or other attacks against oil facilities in the Gulf, which, if successful, could disrupt supply.

### C. Economic Effects of Disruption

- Two previous oil disruptions (1973-74 and 1978-79), during periods when the US had price and allocation controls, led to sharp price increases and contributed to inflation and recession.

In 1973, loss of 6% of world supply quadrupled oil prices (from \$2.86/bbl to \$10.84/bbl); inflation then rose from 6.4% to 10%, and unemployment rose from 3.4% to 8.5%. In 1978-79 the disruption caused by the Iranian revolution resulted in a loss of 1-2 MMBD, most of which was offset by other production. The market reacted to concerns about future supply in a period of expanding demand with low stocks, and spot prices increased from \$13.34/bbl to \$38/bbl. The 1980-81 disruption of Iraqi crude exports caused a small, temporary price increase. Spot prices rose to \$40/bbl and official prices from \$32 to \$34/bbl, from which they have since retreated to \$29/bbl.

- An interagency Data Base Group has modeled five "scenario" disruptions that show that while the risk is low, a major sustained disruption could cause prices to rise sharply and result in substantial GNP losses. Even a smaller disruption could lead to sharp price increases because of market perceptions about the severity, duration and likely consequences. Government actions will influence these perceptions. These projections are based on defined circumstances and periods, and do not reflect the uncertainty likely in a disruption.

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<u>Case</u>	<u>Net Disruption</u> <u>(MMBD)</u>	<u>Duration</u> <u>(Months)</u>	<u>Average</u> <u>Crude</u> <u>Oil/bbl Price</u>	<u>US GNP</u> <u>Loss %</u> <u>Points</u>
1	0	6	30-40	0.0-0.8
2	3	6	35-75	0.6-2.5
3	3	12	35-75	0.8-2.9
4	5	6	50-95	1.3-3.2
5	8	6	70-125	2.3--4.1

-The impacts estimated above are based on the assumption that NO actions are taken to ameliorate the impacts of a disruption. In particular, it is assumed that the SPR is not used, and that the IEP is not triggered (although a disruption of 5 MMBD might and one of 8 MMBD would exceed threshold levels for a general trigger).

-Data Base Group projections indicate that in a disruption causing a net loss of 3 million barrels/day prompt release of the SPR would keep prices in the range of \$30-45/bbl, and that if foreign stocks also are used, prices would be held in the range of \$30-40/bbl. In larger disruptions, similar beneficial price effects would be expected if stocks were released.

#### D. Issues for Decision

- Two sets of issues are within the framework of our present policy: whether and to what extent we should consult with our allies and others before a crisis, and what actions should we take during the first weeks of a crisis? Because any pre-crisis consultations turn on our policy for dealing with a crisis, we discuss first the options for a crisis. Of course, actions under our international energy policy will affect our diplomatic/military and domestic energy policy, and vice versa.

##### 1. During a Crisis

There are three interrelated decisions that will effectively govern how we approach our IEA obligations during a crisis:

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- how should the US approach triggering the IEP-sharing system in the event of a severe disruption? (TAB B)
- to what degree should we seek consultation or coordination with our allies on stock draws? (TAB C)
- should the US support coordinated international action to influence the spot market? (TAB D)

The IEP can be triggered only if one or more members suffer a loss of at least 7% in supply. In less severe ("subtrigger") disruptions, the US has agreed to consult with its IEA allies to determine what, if any, responses are needed. In the early stages of a crisis, the extent of a disruption is likely to be unclear. Even in a subtrigger disruption, the issues of stock draw and spot market actions will be raised, and some countries may raise the trigger. The IESG has not agreed on subtrigger actions.

Under NSDD-87, US policy is to rely on the market and to consult and cooperate with our IEA allies. Triggering the IEP system would interfere with market functioning, but some countries might press it, either for their perceived advantage or as leverage to obtain other actions. Drawing stocks would be consistent with both market functioning and cooperating within the IEA. It is our best weapon to limit economic damage from a supply disruption, and to fend off pressures toward market interference. Actions to influence the spot market are less clear, with some arguing the US intent would be only to provide information, and others arguing such actions are contrary to our market oriented policy.

- IEP Trigger - (TAB B)

The IESG generally agrees that activation of the IEA sharing system should be avoided, especially early in a disruption. Under the Agreement, however, if the Executive Secretariat of the IEA makes a finding triggering the system, it would be difficult for us to block under the voting system. At the same time, most IESG members believe that activation could be delayed if the US offered such alternatives as stock draws and perhaps agreed to spot market actions.

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## - Stock Use - (TAB C)

US policy as recently stated by Secretary Hodel is that early use of the SPR ordinarily is the most effective action we can take to reduce the economic impact of a disruption. Because our allies' stocks are smaller, they might decide to hold their stocks while the US drew down its SPR. The FRG, for example, has formally stated a policy of using its stocks only as a last resort. Congressional and public concern about unilateral stock draw then would become very intense. In light of this concern, the IESG agreed that US policy should support coordinated international stock draws early in a disruption. Any coordinated stock draw must take account of the circumstances should the IEP be triggered and the potential that the US would then earn the right to supplies from other countries.

## - Spot-Market -- (TAB D)

The IESG is divided on the issue of actions to influence the spot market. IEA has in the past attempted to influence companies to restrain "abnormal" spot market purchasing in order to dampen price effects of a disruption. There are no convincing data to demonstrate the effect of jawboning. There is concern that jawboning can be counterproductive, would be seen as the first step toward other government intervention, and that it is not in accordance with the Administration's market-oriented philosophy. Some believe that the apparent effect of jawboning is related to the levels of available stocks (particularly commercial stocks) and market perceptions of future price paths, supply and economic activity. Others strongly believe that the option to approach companies about particular purchases should be retained, and that such efforts by other countries is one means to ensure that the Europeans and Japanese, despite the low level of their stocks, help dampen price spikes and market hysteria. The Europeans and Japanese would likely expect US participation in any IEA efforts to influence the spot market. Other IEA countries may also be expected to apply demand restraint measures prescribed under the IEP.

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2. Pre-Crisis Actions

a. Consultations with Allies on Policy -- (TAB E)

Once decisions on our policy toward triggering the IEA system, drawing on stocks and attempts to influence the spot market have been reached it may be useful to consult other countries bilaterally and in the IEA to describe our policy and preparedness. Although this issue was not discussed in depth in the IESG, most agencies agree on the advisability of advance consultation on crisis management. The Department of State would undertake those consultations working with appropriate agencies, unless a decision is made to the contrary.

b. Urging Stock Build - (TAB F)

Beyond the issue of actions to take during a supply disruption, analysis indicates that stock draws are the simplest mechanism for reducing price impacts of a disruption. In light of concern that other countries are not sharing the burden of preparing to meet disruptions, we considered urging other countries to build their stocks. The US has raised this issue repeatedly in the IEA. The IESG believes that further efforts would be appropriate. Unless a decision is made to the contrary, the US delegation will raise this issue during IEA meetings and bilaterally and develop a strategy for further pursuit of the issue, including the possibility of redefining stocks to take into account the problem of operating inventory.

3. Information Papers (Tabs A - J)

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Issue: Consultations/coordination with our IEA allies on stock drawdown issues	C
Issue: Activities with our IEA allies vis-a-vis the spot market	D
Issue: Desirability of consultation in advance with allies on triggering the IEA system and/or other IEA activities	E
Issue: Initiatives to promote higher stock levels in IEA countries	F
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## THE IEA ALLOCATION SYSTEM (INFORMATION)

### 1. Trigger Mechanism

The emergency oil sharing mechanism of the IEA was designed to assure an equitable sharing of the burden of any serious oil supply interruption among its member countries. Activation of the system is premised on close coordination and the development of a consensus that use of the system is truly necessary. Voting procedures are provided in the event of disagreement, although it is unlikely that those would be used. The IEA oil sharing system can be activated under two types of circumstances: the general trigger would be pulled in the event of an IEA wide loss of oil; the selective trigger for a serious loss to any one country.

-- General Trigger: The general trigger would activate the sharing system whenever IEA countries as a whole have sustained or "can reasonably be expected to sustain" a reduction in oil supplies of at least seven percent of the average daily rate of IEA base period final consumption of petroleum. (The base period is the preceding 4 quarters for which IEA statistics have been calculated.)

-- Selective Trigger: The system can be activated if any individual IEA member sustained or could reasonably be expected to sustain a shortfall of at least seven percent over base period final consumption.

While any IEA member can set in motion the process of making the determination that a trigger situation has occurred, it is expected that the IEA Secretariat would issue a recommendation in the first instance.

-- Voting Arrangements for activation/blocking triggers: When the Secretariat has made a finding that a trigger situation has occurred, it reports to the "Management Committee" which is composed of all IEA members. The Management Committee reports to the Governing Board within 48 hours. The Governing Board has a further 48 hours to meet and review the Management Committee's work. The Secretariat finding that a trigger situation has occurred will in itself cause activation of the system unless the Governing Board by a special majority decides not to activate the system.

Such a decision by the Governing Board to block activation would be difficult to reach. A "special majority" is needed to block a Secretariat finding. This would mean that 15 of the twenty countries voting (Norway as a non-participant

in the IEA plan does not vote) would have to oppose activation and 60% of the combined voting weights would have to be cast in opposition. To satisfy the latter condition, the U.S. would need to be joined for example by Japan, Germany, the UK and Canada in opposition. As can be seen, activation of the system was designed to be virtually automatic after a positive Secretariat finding that the shortfall conditions had been met.

Any member state can request a finding that a trigger situation has occurred. However, in the absence of a positive Secretariat finding, the voting system is skewed to make activation very difficult.

## 2. Calculation for Allocation:

After the IEA trigger has been pulled, IEA members are committed to consuming a percentage less than their normal consumption minus their obligation (if any) to drawdown strategic reserves. In any emergency in which oil supplies to the IEA are cut by seven percent, reduction in demand by each member should be seven percent. In an emergency in which supplies are cut by 12 percent or more, members are obligated to reduce consumption by 10%.

The method of computation of the actual quantities is given below.

The right of an IEA member to oil supplies pursuant to the Agreement (called the "supply right") is calculated as a percentage of Base Period Final Consumption (BPFC) less the Emergency Reserve Drawdown Obligation (ERDO). The BPFC is an IEA calculated figure for the four quarters preceding the last full quarter. (The provision allows the statisticians time to compile data.) Once the IEA trigger is pulled the same BPFC data are used for all calculations. The BPFC is not updated during a disruption. The ERDO is an IEA member's percentage of total IEA emergency reserve commitments multiplied by the amount by which total IEA supplies are less than the amount IEA members would be permitted to consume after a straight demand restraint calculation. (If IEA consumption were 100 units before a 7% disruption, then they would be 93 units after the demand restraint calculation but if IEA supplies available actually totalled less than 93, the IEA secretariat would apportion an emergency reserve drawdown obligation or an ERDO.)

In sum, the system is designed to apportion the shortfalls of a disruption in a fashion proportionate to size, consumption and imports of oil. The formula in a less severe interruption is weighted more heavily towards consumption; in a more severe disruption the weight on imports increases. (The shortfall is not "equally" apportioned as some might assume.)

THIS Appendix discusses the Emergency Sharing System of the International Energy Agency's (IEA) International Energy Program (IEP). The first section addresses the potential of triggering IEP sharing under each of the supply disruption cases previously specified. The second section assesses the supply posture of United States and other IEA nations under IEP sharing. There are assumed to be no policy interventions (such as SPR drawdowns or abnormal stock movements in any case.

### Trigger Calculations

Activation of IEP sharing encompasses a review of both quantitative (e.g., loss of projected supplies) and qualitative factors (e.g., weather, declining demand). This discussion addresses only the technical trigger calculation that compares disrupted supplies with the levels of oil consumption experienced during a previous 12 month period (called the base period). IEP sharing would not, in fact, be activated until the Secretariat makes a finding that the group or an individual IEA member sustains or is reasonably expected to sustain a reduction in oil supplies of at least seven percent of their base period consumption. The finding is then reviewed by the Governing Board of the IEA. The Governing Board could vote by "special majority" to override; or, if the Secretariat declined to make the trigger finding, the Governing Board could activate IEP sharing by a weighted "majority" vote. The "general trigger" could be pulled if remaining supply levels for the IEA as a whole fall seven percent or more below the consumption levels experienced during the base period due to an oil supply disruption. However, the "selective trigger" of the IEP could be pulled if any one or more members' supplies are reduced by this amount.

In disruption Cases 1, 2, and 3, the net loss of free world oil supplies is assumed to range from 0 to 3 million barrels per day (MMBD). Until market forces allocate the available oil, nations that are heavily dependent on oil from the disrupted sources could experience temporary shortages. Although unlikely, several IEA nations that import significant amounts of the disrupted oil could invoke the "selective trigger." Based upon OECD trade data for the first three quarters of 1983, Persian Gulf import dependencies suggest the following candidate countries: Australia, Belgium, Japan, West Germany, Greece, Italy, the Netherlands, Portugal, Spain, and Turkey. The disruptions of 3 MMBD or less are not of sufficient magnitude to cause the "general trigger" to be pulled because they amount to less than 7 percent of total IEA base period final consumption (BPFC).

The oil supply loss in the 2nd quarter of 1984 resulting from a Case 4 disruption would probably be of sufficient magnitude to pull the "general trigger" of the IEP. The net loss of 5 MMBD of available world oil supplies is estimated to result in supply losses in IEA member nations of about 0.2 MMBD in excess of the required 7 percent of their BPFC. Hence, the "general trigger"

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could be pulled. However, this is a borderline calculation and slight changes in the data could result in the trigger not being pulled. The United States' supply right under IEP sharing would be about 14.3 MMBD. This level of supply would be 1.7 MMBD less than the pre-disruption available supplies in the U.S.

The net loss of 8.0 MMBD of available world oil supplies assumed in a Case 5 disruption would result in supply losses in IEA member nations of about 0.6 MMBD in excess of 12 percent of their BPFC. Hence, the "general trigger" could be pulled at the 12 percent level, which requires a 10 percent level of demand restraint. The United States' supply right under IEP sharing would be about 13.5 MMBD, which would be 2.4 MMBD less than pre-disruption available supplies.

It should be noted that these trigger calculations were made based upon the best available historical data and upon the Energy Information Administration's quarterly oil forecast that appears in the February 1983 Short-Term Energy Outlook. Although there is no doubt that the 12 percent trigger threshold is reached in a Case 5 disruption, the pulling of the trigger in a Case 4 disruption is quite borderline. Because the IEA would make the trigger calculation on the basis of their own data and forecasts, it is impossible to predict whether or not they would reach the 7 percent trigger threshold in the Case 4 disruption.

#### Supply Posture of IEA Nations Under Emergency Sharing

Tables 17 and 18 present estimates of allocation rights and obligations for IEA nations under disruption Cases 4 and 5. It is assumed that the "general trigger" of the IEP has been pulled. By definition, a nation incurs an allocation right if its available supplies (the sum of indigenous production and net imports) are less than the supply right determined under the IEP sharing formula. Conversely, an allocation obligation will be incurred if available supplies are greater than the calculated supply right.

Table 17 presents allocation right/allocation obligation estimates assuming that no reallocation of available world oil supplies has taken place due to market forces. In other words, the only imports that a nation loses are those imports from disrupted sources. These results could only occur if world oil prices failed to rise and reduce demand during a disruption. Rights and obligations are derived by comparing these disrupted levels of imports with the import ceilings implied by the IEP supply right calculations. Under this "no reallocation" assumption, the United States would incur an allocation obligation of approximately 1.5 MMBD in a Case 4 disruption and 2.1 MMBD in Case 5.

Table 18 presents allocation right/allocation obligation estimates assuming that market forces have fully reallocated supplies; that is, sufficient time has elapsed such that world oil prices have increased and available oil supplies have been reallocated to reflect those market forces. Rights and

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based on a market solution to estimates of imports based on the IEP sharing formula. The estimates indicate that the United States would incur an allocation right of approximately 0.1 MMBD in disruption Case 4 and 0.4 MMBD in Case 5 once the market had fully reallocated supplies.

It is perceived that the allocation right/allocation obligation estimates presented on Tables 17 and 18 represent a range of extremes. Triggering of IEP sharing would probably dampen market pressures due to non-price demand restraint measures that would be adopted by other IEA countries. Thus disruption impacts presented in Section III would likely be lessened by triggering of the IEP. Table 17 represents a situation that would be very unlikely except in the very earliest stages of a disruption, before market prices rise and supplies are rerouted from their original destinations. As market forces bring about a reallocation of shipments, the situation would gradually evolve toward the equilibrium depicted in Table 18.

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How should the U.S. approach triggering the IEA sharing system in the event of severe interruption?

Current Policy

The U.S. policy emphasizes primary reliance on the domestic and international marketplace both before and, to the extent possible, during an energy emergency. It seeks to improve the functioning of the marketplace before an emergency so that it will operate with maximum efficiency once an emergency occurs. (NSDD-87, p.1.) The primary mechanism to protect against the worst effects of such emergencies is maintenance of stockpiles, including the SPR.

The U.S. has reaffirmed its commitment to meet its obligations under the International Energy Program (IEP) and is prepared to consult and to cooperate with its IEA partners in the event of a disruption in order to reduce panic, to minimize economic dislocations, and to ensure that individual countries do not suffer unacceptable harm as a result of the shortfall in oil supplies. The U.S. is prepared to consult and cooperate with IEA partners toward these ends, especially to foster market pricing of energy supplies and to increase stock levels, and to exchange information on national use of stocks (NSDD-87, pp. 9-10).

Background

The emergency oil sharing mechanism of the IEA is designed to assure an equitable sharing of the burden of any serious oil supply interruption among its member countries. Activation of the system is premised on close coordination and the development of a consensus that use of the system is mutually beneficial. Voting procedures are provided in the event of disagreement, although it is unlikely that those would be used. The IEA oil sharing system can be activated under two types of circumstances:

-- General Trigger: The general trigger would activate the sharing system whenever IEA countries as a whole have sustained or "can reasonably be expected to sustain" a reduction in oil supplies of at least seven percent of the average daily rate of IEA base period final consumption of petroleum. (The base period is the preceding 4 quarters for which IEA statistics have been calculated.)

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-- Selective Trigger: The system can be activated if any individual IEA member sustained or could reasonably be expected to sustain a shortfall of a least seven percent over base period final consumption.

# 1. Selective Trigger Situation

Analysis - The IEA Secretariat has expressed the view that activation of the sharing system would be inappropriate either in a crisis of short duration or when the direct effects of a disruption are limited to one or two countries because of the dislocations in normal commercial practices that would follow triggering of the system. In this light, alternative supply arrangements or cargo diversions by the U.S. alone or by the IEA as a whole could be considered. Because price is a critical issue for the smaller IEA countries in particular, and because a disproportionate supply shortfall can persist only if the country is failing to pay world market prices, the first priority may be to try to persuade these countries to abandon price control policies and purchase on the open market. Such attempts however, are likely to be met by requests for international financial assistance.

Several smaller IEA countries are likely to be of significant importance to us because of the presence of U.S. base facilities and for their strategic importance in NATO. Portugal, Turkey, Greece and perhaps Spain fall into this category. If it is U.S. policy to assist these countries in obtaining oil supplies in the event of a serious disruption, we will need to decide whether to do so through the IEA allocation (i.e. use the selective trigger device) or to do so outside the IEA through bilateral or multilateral efforts directly with international oil companies. Concerted international effort to assist those countries most heavily affected by a smaller scale crisis could avert the need to activate the selective trigger mechanism.

## Options

-- Seek to postpone activation of trigger and encourage affected countries to work with not against market forces. This option, if it succeeds, permits delay in creating the economic dislocations inherent in the allocation system and provides maximum flexibility for the market to work. However, it may alienate key allies, especially those where U.S. bases are located.

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-- Seek to postpone activation of the trigger by attempting to arrange for alternative supplies at market prices. (Such activity might follow the lines of the effort undertaken in response to a request from Turkey during the 1980 disruption. U.S. companies were contacted by DOE and State officials and asked to assist Turkey in locating oil supplies. DOD's Defense Fuel Supply Center also made an offer of oil products to Turkey.)

This option shows some U.S. willingness to cooperate with affected countries, but avoids any direct expenditure of U.S. funds. The prospects for success of such an option may be limited, however, leading to requests for financial assistance (following option).

-- Seek to postpone activation by mobilizing alternative assistance both in terms of locating supplies and providing credit and/or financial assistance. This option also provides great flexibility and permits a more complete assessment of the real nature of the problem faced by the affected country or countries. Some USG loans or financial assistance would be required. Amounts could be substantial. For example, financing a 10 percent loss in Turkish consumption could require financial assistance up to \$125 million per quarter at \$40 per barrel.

-- Support selective trigger activation in the event of a request. This option demonstrates to our allies U.S. faith in the IEP system, and as an announced policy would contribute to U.S. interests in the early phases of another selective embargo against the U.S. As a realistic option in the event of a serious crisis, however, it may not provide sufficient time for analysis of the parameters of the crisis if those requesting the trigger activation press their case during the initial stages of the disruption.

## 2. General Trigger Situation

Analysis - Some countries will seek to trigger the IEA Emergency Sharing System as early as possible in a serious disruption. The U.K. has already informed us that it prefers early activation in order to dampen upward price pressure and discourage speculative buying. Japan may also press for early activation. The IEA consultations prior to activation will provide an opportunity for the U.S. to put forward its own analysis of the severity of the crisis and the likely utility of activating the general trigger. If an attempt is made to pull the trigger quickly, however, the consultations could be extremely brief. Moreover, in the face of substantial pressure from a number of IEA members, the U.S. may not be able to prevent activation unless specific alternatives meeting the

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countries' needs are presented.

We will want to give careful consideration to the use of stocks as an alternative to early trigger action. At the onset of a serious crisis, we are likely to be faced with incomplete information on damage which may have occurred to key Persian Gulf oil facilities or to be faced with a conflict of uncertain duration. Early coordinated use of stocks could calm markets and add to supplies, allowing a clearer judgement to be made somewhat later on the need to activate the sharing mechanism.

Options

-- Seek to delay activation to the greatest extent possible. This option will provide maximum flexibility to the U.S., permit markets to clear, permit the gathering of more complete information as to the extent of the crisis before engaging the complicated IEP system, and enable the IEA partners to consult on appropriate measures short of full activation. This option could prove very divisive in terms of a unified IEA approach to the crisis in that it is likely to be unacceptable to IEA members suffering particularly acute supply problems. Given the nature of our IEP commitment, therefore, this option could probably not be exercised in the most severe crises (i.e. case 5).

-- Act with reserve in triggering the system, and urge coordinated stock drawdowns in place of early trigger. This option will help maintain a sense of unity in the crisis, and also may permit a greater exchange of information and views on the crisis than if the U.S. were perceived as holding back from cooperative measures. This option assumes U.S. willingness to discuss and agree on an early coordinated release of stocks.

-- Support early trigger action. This option would meet the demands of those IEA countries most seriously affected by a supply interruption and in the view of most European countries would help calm the oil market during what is potentially the most volatile period of a severe crisis. But information about the nature, depth and extent to the crisis will also be least available during the same period of time. This option is inconsistent with the policy of maximum reliance on markets.

### 3. Less than Severe (Subtrigger) Disruption

Our analysis indicates that the IEA emergency oil sharing system would not be activated in smaller scale interruptions. Disruptions of 3MMBD or less would not be of sufficient magnitude to cause the "general trigger" to be pulled because they amount to less than 7% of the IEA base period final consumption.

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Administration policy is to seek to preserve maximum decision-making flexibility for dealing with interruptions when and if they occur, and to place primary reliance on the marketplace both before and during an energy emergency. This flexibility and marketplace reliance are most important when dealing with a subtrigger disruption, to ensure that the response to such disruptions does not actually increase the economic harm resulting from the disruption. The U.S. has agreed with its IEA counterparts, however, to meet promptly and to consider a variety of actions to avoid serious economic damage to the member countries.

Attachment:

Impacts of the International Energy Program: Data Base and Analysis Group

OF INTERNATIONAL ENERGY AGENCY NATIONS  
PRIOR TO ANY MARKET ALLOCATIONS

(2nd QUARTER 1984, MID-ESTIMATE ASSUMPTIONS)

CASE 4

(NET SHORTAGE = 5.0 MMB, WORLD OIL PRICE = \$29)

	<u>NET DISRUPTED IMPORTS</u>	<u>NET IEP IMPORTS</u>	<u>ALLOCATION: RIGHT (+) / OBLIGATION (-)</u>
United States	5.5	4.0	-1.5
Canada	0.0	-0.3	-0.3
Japan	2.9	3.4	0.5
Australia/New Zealand	0.0	0.1	0.1
Norway/Sweden	-0.1	-0.1	0.0
United Kingdom/Ireland	-1.2	-1.1	0.1
Benelux/Denmark*	1.0	1.1	0.1
West Germany	2.0	1.8	-0.2
Austria/Switzerland	0.4	0.3	0.0
Spain/Portugal	0.8	0.9	0.1
Italy	1.1	1.3	0.2
Greece/Turkey	0.2	0.4	0.2

CASE 5

(NET SHORTAGE = 8.0 MMB, WORLD OIL PRICE = \$29)

	<u>NET DISRUPTED IMPORTS</u>	<u>NET IEP IMPORTS</u>	<u>ALLOCATION: RIGHT (+) / OBLIGATION (-)</u>
United States	5.3	3.2	-2.1
Canada	0.0	-0.3	-0.3
Japan	1.9	2.9	1.0
Australia/New Zealand	-0.1	0.0	0.1
Norway/Sweden	-0.1	-0.1	0.0
United Kingdom/Ireland	-1.2	-1.1	0.1
Benelux/Denmark*	0.9	1.0	0.1
West Germany	2.0	1.5	-0.4
Austria/Switzerland	0.4	0.3	-0.1
Spain/Portugal	0.6	0.8	0.2
Italy	0.9	1.1	0.2
Greece/Turkey	0.1	0.3	0.2

\*Benelux = Belgium, the Netherlands, and Luxembourg.  
Note: Numbers may not be precise due to independent rounding.

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TABLE 18  
THE ALLOCATION RIGHTS / OBLIGATIONS  
OF INTERNATIONAL ENERGY AGENCY NATIONS  
AFTER A FULL FREE MARKET ALLOCATION

(2nd QUARTER 1984, MID-ESTIMATE ASSUMPTIONS)

CASE 4

(NET SHORTAGE = 5.0 MMBD, WORLD OIL PRICE = \$57)

	<u>NET MARKET IMPORTS</u>	<u>NET IEP IMPORTS</u>	<u>ALLOCATION: RIGHT (+) / OBLIGATION (-)</u>
United States	3.9	4.0	0.1
Canada	-0.2	-0.3	-0.1
Japan	3.5	3.4	-0.1
Australia/New Zealand	0.0	0.1	0.0
Norway/Sweden	-0.2	-0.1	0.1
United Kingdom/Ireland	-1.2	-1.1	0.2
Benelux/Denmark*	1.1	1.1	0.0
West Germany	1.9	1.8	-0.1
Austria/Switzerland	0.3	0.3	0.0
Spain/Portugal	0.9	0.9	0.0
Italy	1.3	1.3	0.0
Greece/Turkey	0.4	0.4	0.0

CASE 5

(NET SHORTAGE = 8.0 MMBD, WORLD OIL PRICE = \$79)

	<u>NET MARKET IMPORTS</u>	<u>NET IEP IMPORTS</u>	<u>ALLOCATION: RIGHT (+) / OBLIGATION (-)</u>
United States	2.9	3.2	0.4
Canada	-0.3	-0.3	0.0
Japan	3.2	2.9	-0.3
Australia/New Zealand	0.0	0.0	0.0
Norway/Sweden	-0.2	-0.1	0.1
United Kingdom/Ireland	-1.3	-1.1	0.2
Benelux/Denmark*	1.0	1.0	0.0
West Germany	1.8	1.5	-0.3
Austria/Switzerland	0.3	0.3	0.0
Spain/Portugal	0.8	0.8	-0.1
Italy	1.2	1.1	-0.1
Greece/Turkey	0.3	0.3	0.0

\*Benelux = Belgium, the Netherlands, and Luxembourg.

Note: Numbers may not be precise due to independent rounding.

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ISSUE:

To what degree should we seek consultations and/or coordination with our Allies on stock drawdown issues?

Current Policy

The Administration seeks to preserve maximum decision-making flexibility for dealing with interruptions when and if they occur; however, the U.S. is prepared to consult with its IEA partners to exchange information on the national use of stocks (NSDD-87).

U.S. concerns have centered on maintaining flexibility in deciding the timing and drawdown rate of the SPR, and assuring that control over private sector stocks remains in the hands of the private sector.

Analysis

Several factors are relevant in examining the issue of the degree to which international stock draw coordination should take place. The first is the need to retain control over the use of the SPR. We have invested as a nation over \$11 billion in building our SPR. Obviously, we do not want to cede control to other nations over this vital resource.

On the other hand, the U.S. has substantially more stocks than any other importing nation, compared to its import levels. The control of the USG over the bulk of its useable stocks is also more direct than that of other IEA nations. Most other IEA nations hold lower proportions of government stocks or none at all and rely on mandatory stock levels which can be lowered in the event of a crisis. Probably no more than 50% of these commercially held mandatory stocks are useable -- the rest are needed for minimum operating requirements. The leading IEA stock holding nations hold stocks as follows below:

## STOCKS ON LAND (January 1, 1984)

<u>COUNTRY</u>	<u>STOCK LEVEL*</u>	<u>DAYS FORWARD CONSUMPTION</u>	<u>DAYS 1983 NET IMPORTS</u>
United States	1,418.25	96	311
Japan	454.5	94	105
FRG	278.25	118	130
Italy	211.5	75	93

\*Million barrels (complete table attached)



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The above figures can be misleading if the minimum operating requirement is not kept in mind.

It is important to understand that a unilateral release of strategic oil stocks by the U.S. will place an inordinate burden on us and will dilute the effects of the SPR. Because of the integrated nature of the world oil market, a release of stocks from the U.S. SPR will benefit consumers of oil worldwide by providing extra supplies. Administration policy has in fact moved toward early release of the SPR. In his testimony February 21, Secretary Hodel said that "in a major disruption, the early sale of SPR oil in large volumes is ordinarily the best policy for SPR use...The market place needs to know in advance that this is our general policy so that unnecessary panic behavior can be avoided." If the U.S. pursues such a policy of early release, however, other IEA nations may decide to retain their smaller oil stocks against the possibility of a worsening of the disruption. The FRG's policy, for example, is to use its stocks as a last resort measure. Consultations with Europe and Japan may be needed to assure that this does not happen.

Our analysis indicates that rapid use of the SPR in Case II disruption (3 MMBD net disruption lasting six months) would reduce oil prices by \$5 to \$30 per barrel below what prices would have been had the SPR not been used. Instead of rising to \$35 to \$75 per barrel, prices are projected to be held to a range of \$30 to \$45 per barrel. In the event that foreign government controlled stocks were also utilized, prices are projected to be held to a range of \$30 to \$40 if a disruption took place in the second quarter of 1984. The projected benefits of simultaneous drawdown of foreign government stocks become larger as the disruption size increases. An additional price reduction of \$5-15 would take place in Case IV (5 MMBD net disruption) and Case V (8 MMBD) net disruption where foreign controlled stocks are drawn together with the SPR vs. the case where the SPR alone is drawn.

There have been no consultations with our IEA partners on plans for coordination of stock drawdowns to date.

Most European IEA members (but notably excluding FRG) have long argued that some release of government controlled stocks at an early stage of even a small scale disruption could have a beneficial effect in avoiding price run-ups. In the past, U.S. attempts to press for higher stock levels have been met with European demands for use of these stocks in a so-called "sub-trigger" situation, i.e., one in which

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the sharing system is not activated. Present U.S. policy continues to be that the market should be allowed to function unimpeded in the event of a small scale disruption.

In a large-scale disruption, coordinated release of government stocks could be considered either before or after activation of the IEA sharing system. If, for example, conflict in the Persian Gulf disrupted supplies on a major scale, but for an unknown duration, early coordinated use of strategic stocks might be called for as an alternative to immediate activation of the IEA sharing system.

Coordination of stock drawdowns in a trigger situation, may not be feasible. In the event of a severe petroleum interruption and triggering of the IEA sharing formula each member country would be required to limit petroleum imports to levels determined under the formula. Since each member country is permitted to use a range of methods to limit imports e.g., fuel switching, stock drawdown, demand reductions through price or government regulation, any attempt to coordinate stock drawdown will be difficult if not impossible if the IEA is triggered. Therefore, coordinated stock drawdown should be evaluated as an alternative to triggering the IEA.

#### OPTIONS

-- Coordinated government statements. Attempts by governments at the onset of a serious disruption to lessen the perception of crisis and calm the fears of market participants could be very useful. An internationally coordinated public policy statement encouraging private stock draws, where possible, could have particular effect because of the importance of stock draws in reducing the impact of a disruption. On a worldwide level however, commercial stocks are relatively low and the positive effects of their drawdown would be of marginal utility. Moreover, USG guidance to U.S. companies on when to draw stocks would be inconsistent with a market reliance policy.

-- Seek advance agreement on coordinated release of government-controlled stocks as an alternative to triggering the IEA. A major U.S. concern continues to be that advance attempts at stock policy coordination with our allies would limit U.S. flexibility in SPR policy. Because the U.S. has the highest stock levels, it would face demands by other countries to draw the earliest and at the highest rates. On the other hand, if the U.S. pursues a policy of early drawdown of the SPR, it will be much to our advantage to have other IEA nations drawing their stocks as well. A general coordinated release plan may be necessary to assure a European and Japanese draw.

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-- Do not pursue advance agreements, but make decisions on a coordinated stock approach if and when an interruption occurs. This option most closely follows current Administration policy of maintaining maximum flexibility with respect to the use of stocks. In a disruption the size of case 4, and especially case 5, however, it may not permit adequate time to engage in necessary consultations with our allies should we desire to pursue coordination. It may, therefore, result in IEA member government-controlled stocks not being drawn down in the earliest stages of the disruption, thus reducing the ultimate benefits of the drawdown.

-- Assure IEA members that the U.S. favors mutually supportive stock draws, but refuse to establish specific conditions in advance for their release. Instead, we would rely upon consultations to frame the appropriate timing and level of stock draw for a given disruption.

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## STOCKS ON LAND IN IEA COUNTRIES\*

January 1, 1984

	Stock Level		Days	Days	Days
	<u>MMT</u>	<u>Mbbl</u>	<u>Forw.</u>	<u>1983</u>	<u>1981/83</u>
			<u>Cons</u>	<u>Net</u>	<u>Av. Net</u>
				<u>Imps.</u>	<u>Imports</u>
Canada	15.6	117.00	73	-	7,527
United States	189.1	1,418.25	96	311	300
North America	204.7	1,535.25	93	311	324
Australia	4.7	35.25	71	299	222
Japan	60.6	454.50	94	105	184
New Zealand	.7	5.25	63	87	81
Pacific	66.0	495.00	92	110	108
Austria	3.3	24.75	120	140	131
Belgium	5.1	38.25	86	104	97
Denmark	5.0	37.50	147	223	195
Germany	37.1	278.25	118	130	126
Greece	3.7	27.75	119	118	116
Ireland	.9	6.75	68	80	70
Italy	20.2	151.50	75	93	89
Luxembourg	.2	1.50	70	82	80
Netherlands	12.0	90.00	159	283	256
Norway	2.2	16.50	93	-	-
Portugal	2.4	18.00	89	70	72
Spain	10.1	75.75	71	78	73
Sweden	6.4	48.00	116	133	113
Switzerland	6.0	45.00	156	172	174
Turkey	2.0	15.00	44	43	46
United Kingdom	15.7	117.75	70	-	-
IEA Europe	132.3	992.25	96	117	112
IEA	403.0	3,022.50	94	170	170

\* A portion of these stocks represent minimum operating requirements for refineries, pipelines, etc. Between 40-60% of privately held stocks are probably unuseable in a crisis.

1. Stock levels adjusted per IEA definitions using crude or equivalent.
2. Products adjusted by 1.065.
3. IEA data is given in metric tons; conversion to barrels is based on 7.5 barrels per ton.
4. Stocks include crude oil and products.

SOURCE: IEA Data

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II e

ISSUE:

Should the U.S. support coordinated international action to influence the spot market?

Current Policy

Administration policy precludes government intervention in oil markets except in severe petroleum supply disruptions when the IEP is triggered. However, in the event of any disruption, we do support consultations with other IEA countries to assess the magnitude of the interruption and to discuss what, if any, IEA country actions would be appropriate to reduce panic and to minimize economic dislocations. These consultations would include discussion of whether to discourage "abnormal" spot purchases that could further disrupt the market.

Analysis

The crude oil spot market has grown in importance in recent years as demand has weakened, OPEC's share of world oil trade has declined, and purchasers have relied less on long-term contracts. Data on the spot market is difficult to gather because cargoes on the high seas are often sold many times through the spot market before finding their way to refineries. Although no reliable figures are available, we estimate that 20-30 percent of internationally-traded crude oil is never subject to term contracts, and some term contract crude is also eventually resold on the spot market after liftings take place. Hence, what happens to the price of oil on the spot market has a profound effect on term contract prices, including those for OPEC oil.

Spot markets respond both to real supply shortages and political, strategic (preparedness level), psychological, and perceptual factors. Thus, any influence to be exercised over spot market price increases, similar to that attempted by the IEA during 1979-80, must be directed to all these factors as well as to the underlying supply problem. IEA efforts during that period to discourage spot market purchases at excessive prices were accompanied by efforts to spread reliable information on market conditions so as to reduce market panic. However, there is disagreement about the utility of the IEA intervention.

Spot markets can be influenced in two ways. The first and most effective method is to change the fundamentals of

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the market, i.e., to decrease demand or to increase supply. Increased production and stock drawdown both provide a deterrence to spot market panic. A second approach is to disseminate information and discourage speculative behavior. Some observers argue that government intervention measures such as "jawboning" oil purchasers have beneficial effects in reducing upward price pressures. Such efforts, it is argued, are likely to have the greatest effect when combined with efforts to gather and disseminate reliable information about market conditions to a broad audience. Others believe that the reverse is true and that such government intervention has perverse effects on market behavior.

In 1980 the IEA Governing Board adopted an overall declaration calling on all members to encourage their companies to avoid spot market purchases wherever possible. This decision was implemented through close coordination among governments. For example, U.S. officials notified the Japanese Government on several occasions when there were reports of Japanese companies making major spot purchases. We in turn contacted U.S. companies to urge forbearance as we became aware of reports of major U.S. activity on the spot market.

Proponents argue that jawboning could limit "panic" purchases and thus "excessive" increases in the world oil price. They base their view on the fact that prices increased at the beginning of the Iranian revolution when there was no jawboning, but did not increase at the outbreak of the Iran/Iraq war, when there was jawboning. Critics of jawboning, however, attribute this difference in price behavior to basic differences in the supply and demand situation.

Some believe that jawboning will in fact make the crisis worse. It may inadvertently bring about panic purchases by the oil companies. The oil companies may view our attempt at jawboning as the first step to more pervasive control over their inventory behavior. Their reaction will be to buy as much oil as possible before the government imposes inventory controls. In addition, any executive that follows our advice without legal sanction will open himself up to a stockholder's suit. Finally, some believe jawboning may lull government officials into believing that they are effectively addressing the supply disruption and providing an excuse to avoid the more difficult decision of whether or not to use the SPR.

#### OPTIONS

Allow the market to work unencumbered as it has since 1981, and make no attempt to influence the behavior of market participants. This option is consistent with Administration policy of market reliance. It may be, however,

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especially in a situation where drawdown of government-controlled stocks is delayed or perceived by the industry not to be sufficient, that some market participants will engage in activities such as large-volume speculative purchases which, if unchecked, may significantly increase spot market pressures and result in price spikes of the nature seen in 1978/79.

Conduct a public information campaign urging restraint in spot market purchases. This option may help to restrain demand. However, in the absence of legal constraints, we do not know how effective such a campaign would be, and some believe it may be counterproductive. This approach may be seen by some as inconsistent with a market reliance strategy.

As a variant of this option, U.S. oil companies could be advised directly by senior Administration officials that spot market behavior, if it was viewed as excessive by the Congress, could have counter-productive consequences in terms of encouraging price and allocation control legislation.

Argue that IEA members already heavily involved in market activities may act to restrain speculation, while focusing USG activities on stock drawdown and public information. This option would recognize that there is little we can do to influence the activities of the Europeans and Japanese in this area, but would avoid divisive splits in the IEA. (This option and the preceding option could be taken together.)

Take direct action with our IEA partners such as that taken during 1980 by the IEA to influence market participants. This action may restrain demand more effectively than either of the first two options because it combines "jawboning" (seen by some as more effective than a public relations campaign) with dissemination of reliable market information, which, especially in a most serious disruption, can lead to calm markets. Others believe this option will be counterproductive and seriously erode the Administration's market reliance policy in that it could also lead to domestic pressure for more substantial intervention in the market.

For instance, jawboning techniques may create a sense of "shortage paranoia" that otherwise may not have existed. Also, jawboning involves the presumption that governments are in a better position to make market decisions than the companies directly involved in it through their daily transactions. But companies refraining from making spot market purchases at the behest of the government may later be disadvantaged, particularly if the disruption worsens and prices, as a result, increase precipitously.

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CONFIDENTIALISSUE:

Once we have completed a review of our own emergency planning, should we engage in advance bilateral consultations with our allies on triggering the IEA system and other aspects of emergency preparedness?

CURRENT POLICY:

Maintain strong and continued cooperation with other major energy consuming countries to reduce panic, minimize economic dislocations and assure that individual countries do not suffer unacceptable harm as a result of a shortfall in oil supplies. To these ends, the U.S. seeks to foster market pricing of energy supplies, to increase stock levels, and to exchange information on national use of stocks. (NSDD-87, p. 9).

BACKGROUND:

The British have on several occasions told us they would welcome consultations on the situation in the Persian Gulf and our views on how to deal with the energy effects of a potential conflict. The Japanese have been active in consulting with the Europeans about IEA and emergency policy, and have also asked for consultations with us. We have undertaken no systematic consultations with other IEA members on energy emergency preparedness issues in connection with the current Persian Gulf situation.

DISCUSSION:

As noted in previous papers, some discretion is provided in the IEP with regard to triggering the IEA System, especially in cases where the duration of an interruption is uncertain. Once a decision has been made within the U.S.G.-on trigger policy, we may find it to our advantage to consult with key allies on our rationale and seek their support. This would have the distinct advantage of minimizing disagreement at the onset of a supply crisis.

Such consultations could also involve several other areas such as:

- a) coordination of the tenor of public statements to be made at the onset of a crisis.

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- b) Exchange of views on parallel attempts to calm the market and assure adequate dissemination of information.
- c) consultations and exchange of information on stock draw policies.
- d) discussion of developments in the Middle East from an energy perspective.

In addition, we may wish to consult the Canadians with regard to increased exports of natural gas to the U.S. in the event of an emergency. We estimate that Canada has 1.5 MMCF/D of shut-in capacity, 2/3 of which is available to the U.S. under present Canadian export authorizations, and more could be made available in a crisis.

OPTIONS:

- a) undertake no consultations in advance of a crisis on the premise that our policies have been adequately explained to our allies. This would preserve maximum U.S. flexibility in dealing with any crisis. No detailed consultations have been undertaken with our allies on energy contingency planning in recent months.
- b) undertake consultations in connection with other regularly planned IEA meetings. An upcoming meeting of the IEA Governing Board at the end of March could be used to outline U.S. thinking on energy emergency planning.
- c) send two or three U.S. officials to Europe, Canada, and Japan to ensure full allied coordination of preparations to deal with an energy supply interruption. This would allow for more detailed discussion with individual countries of detailed plans and probably result in more effective coordination, but might raise expectations that we are willing to commit to specific SPR drawdown plans. Consider whether these energy consultations should be undertaken together with the politico-military contingency planning being done with our allies.

F

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To what extent are IEA country stocks adequate? To what extent should efforts be made to increase stocks of IEA member states?

CURRENT POLICY AND BACKGROUND

The International Energy Program (IEP) requires that IEA members maintain an emergency reserve equal to 90 days of net oil imports. A table of current IEA member stock levels is attached. While IEA members on the average hold land-based stock equal to 170 days of net oil imports, the U.S. currently has nearly 300 days of 1980-83 average net oil imports in "land based" stocks. The 90-day requirement, is currently met by all IEA members except Spain, New Zealand, Turkey, Ireland, Luxembourg, and Portugal. It should be noted that these figures represent total oil stocks held in these countries. A portion of these stocks represent minimum operating requirements for refineries, pipelines etc. Between 40-60% of privately held stocks are therefore probably unusable in a crisis, although this percentage may vary according to price.

Discussion

We can pursue several approaches with other IEA members to increase overall IEA stock levels. One possibility would be to press countries with less than 90 days of stocks to comply with the IEP. New Zealand, Ireland, and Luxembourg have 80 days of stocks or more. Portugal, with stocks of 72 days and a weak economy, would have greater difficulty than these countries in meeting the IEP requirement. Stock builds by these countries would not, however, materially affect total IEA stocks in any event. They might, however, reduce pressures in an emergency for trigger activation or for financial assistance.

Stock builds by Spain and Turkey would be somewhat more meaningful. Spain, with consumption of about one million barrels per day, now has 73 days of stocks. Turkey, which consumes about 300,000 b/d, would need substantial investments to double its current stock level from 43 days to the 90 day requirement. Both countries have special military significance, but neither is likely to build stocks without outside pressure. Even with large stock builds by these countries, overall IEA stock levels would not significantly improve, although their individual dependence on the U.S. would be reduced.

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Another possibility involving bilateral efforts would be to ask IEA members that already meet the IEP stock requirement to build their stocks further over the next two years. Further builds by Japan and the FRG, which have the largest IEA stockpiles after the United States and both of which exceed the IEP stock requirement, would be especially helpful. Overall Japanese stock levels exceed the 90 day requirement by 15 days (the minimum operating level requirement, of course, means this figure overstates stocks available in a crisis), but the Japanese have been reluctant for financial reasons to emphasize government stocks. In this regard, Japanese government-owned and controlled stocks are at only 23 days.

We have strongly encouraged the Japanese to increase both overall and government stock levels on many occasions over the last several years, including specific appeals to Japan in the IEA Governing Board. They have responded by resuming the filling of government-owned stockpiles. Despite this movement, Japan remains especially vulnerable to a disruption because of its heavy dependence on imports and on the Gulf as a supplier.

The Germans, with 130 days of stocks, also exceed their IEP obligation. The German equivalent of the SPR contains about 55 million barrels of crude oil, and the FRG also has stocks of petroleum products held by a semi-private company amounting to approximately 100-115 million barrels. These two stocks together equal 90-100 days of German consumption additional to normal commercial inventories.

After the U.S., Japan, and the FRG, Italy holds the largest stocks among IEA members. The Italians are currently at the IEA requirement level but could also be encouraged to build their stocks more rapidly. Taken together, stock builds over current levels by Japan, the FRG, and Italy, could have a significant impact on enhancing Western emergency preparedness generally and in increasing IEA stock level specifically.

We might also work within the IEA to raise the IEP requirement to more than 90 days of stocks, perhaps to 100-110 days. In 1982 we supported an IEA Governing Board decision to increase emergency stock levels. At its December 1982 meeting the Governing Board reaffirmed a decision to require that "member countries make efforts not to let stocks fall below" 90 days of net imports. The Governing Board also took a decision to require the calculation to be based on the higher of the average net imports from the previous three calendar years or the average net imports during the single previous calendar year, e.g., during 1984, this would be the larger of 1980-1982 average net imports or 1983 average net imports. Although any

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Governing Board decision did not completely satisfy us, we did not press the issue at that time since the European IEA members linked it to consideration of a stock drawdown in a short supply situation not sufficient to activate the IEA sharing system (the so-called "sub-trigger" situation).

Although we should not be overly optimistic about short-term success in effecting a change in IEA stock requirements, persistence on our part might yield longer-term results and would be responsive to concern on the part of Congress and elsewhere that the U.S. is bearing an unfair portion of the free world's stockpile burden.

Options:

- I. Undertake bilateral efforts to persuade those countries below 90 days, in particular Spain and Turkey, to raise their stock levels at least to IEP mandated levels. This would demonstrate to smaller IEA countries that we continue to press them to meet their IEA commitments. Given the financial constraints of these countries, however, chances of success are limited.
- II. Press key consumer countries (especially Japan) to raise stock levels by substantial amounts over the next two years. This would have the key advantage of providing significantly higher stocks world wide; however, pressure by the U.S. over the past two years has produced only limited results.
- III. Seek an amendment to the IEP raising stock requirements to 100-110 days. Such a change in the IEP would require Congressional approval, opening the way for extensive Congressional consideration of emergency preparedness issues.
- IV. Undertake all of the actions described above.

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## STOCKS ON LAND IN IEA COUNTRIES\*

January 1, 1984

	<u>Stock Level</u>		<u>Days</u>	<u>Days</u>	<u>Days</u>
	<u>MMT</u>	<u>Mbbl</u>	<u>Forw.</u>	<u>1983</u>	<u>1981/83</u>
			<u>Cons</u>	<u>Net</u>	<u>Av. Net</u>
				<u>Imps.</u>	<u>Imports</u>
Canada	15.6	117.00	73	-	7,527
United States	189.1	1,418.25	96	311	300
North America	204.7	1,535.25	93	311	324
Australia	4.7	35.25	71	299	222
Japan	60.6	454.50	94	105	184
New Zealand	.7	5.25	63	87	81
Pacific	66.0	495.00	92	110	108
Austria	3.3	24.75	120	140	131
Belgium	5.1	38.25	86	104	97
Denmark	5.0	37.50	147	223	195
Germany	37.1	278.25	118	130	126
Greece	3.7	27.75	119	118	116
Ireland	.9	6.75	68	80	70
Italy	20.2	151.50	75	93	89
Luxembourg	.2	1.50	70	82	80
Netherlands	12.0	90.00	159	283	256
Norway	2.2	16.50	93	-	-
Portugal	2.4	18.00	89	70	72
Spain	10.1	75.75	71	78	73
Sweden	6.4	48.00	116	133	113
Switzerland	6.0	45.00	156	172	174
Turkey	2.0	15.00	44	43	46
United Kingdom	15.7	117.75	70	-	-
IEA Europe	132.8	992.25	96	417	412
IEA	403.0	3,022.50	94	170	170

\* A portion of these stocks represent minimum operating requirements for refineries, pipelines, etc. Between 40-60% of privately held stocks are probably unuseable in a crisis.

1. Stock levels adjusted per IEA definitions using crude or equivalent.
2. Products adjusted by 1.033.
3. IEA data is given in metric tons; conversion to barrels is based on 7.5 barrels per ton.
4. Stocks include crude oil and products.

SOURCE: IEA Data



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ISSUE: What should be done to encourage Japan to significantly increase its strategic petroleum stocks in order to be adequately prepared for a severe interruption?

### BACKGROUND/ANALYSIS

By far, the largest government stockpile, both in volume and relative to oil import needs, is held by the U.S., followed by Germany and Japan. As a frame of reference, the oil imports, oil consumption and oil dependence for each of these nations for 1982 is provided below:

	<u>Net Oil Imports (MB/D)</u>	<u>Oil Consumption</u>	<u>Imports % of Oil Consumption</u>	<u>Oil as % Total Energy Consumption</u>
United States	4.1	15.3	27	43
West Germany	1.9	2.0	95	39
Japan	4.2	4.2	100	58

As indicated, Japan is by far one of the most highly dependent of the industrialized countries on oil imports and consumption.

### Comparison of Petroleum Stock Levels

Shown below are current government-owned strategic stocks and government plus private sector stocks. As can be seen, Japan lags behind the U.S. and West Germany in the oil import coverage provided by its government strategic stockpile.

	<u>Government-Owned Strategic Stocks</u>		<u>Total Private and Government Stocks</u>		
	<u>Millions of Barrels</u>	<u>Days of 1982 Net Oil Imports</u>	<u>Millions of Barrels</u>	<u>Days of 1982 Net Imports</u>	<u>Days of 1982 Oil Consumption</u>
United States	385	95	1,440	355	95
Japan	79	19	418	100	100
West Germany <sup>1/</sup>	55	28	289	149	145

<sup>1/</sup> Germany also has about 132 MB (68 days of net 1982 imports) held by a special corporation. We estimate that about 90 MB of the 132 MB are "strategic stocks", in part government financed, for a total of 145 MB or approximately 75 days of net imports.

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Japan has not made much progress in the last year in filling its government stockpile in spite of statements that it wishes to raise the reserve expeditiously to about 190 million barrels. In contrast, the U.S. added 64 MB to the SPR last year. Nor is Japan expected to make much progress in the current fiscal year: JNOC plans to increase its crude oil stockpiles to only 15 million kiloliters (about 93 million barrels) by the end of fiscal 1983. This represents a fill rate of only 50,000 b/d, in comparison to the current U.S. fill rate of 186,000 b/d in 1984 and 145,000 in 1985. Listed below is the fill schedule for the U.S. SPR compared with current Japanese fill. The FY84 budget proposal to Parliament includes funding to increase the government oil stockpile to about 32 days of net oil imports by March 1985.

<u>Date of Completion</u>	<u>Japan</u>		<u>U.S. 1/</u>
	<u>(Storage Capacity)</u>		<u>(Oil Stored)</u>
	----- Million Barrels -----		
Current Fill	80 (fill)		327
FY 1985			448
FY 1987			520
FY 1988			557

1/ President's Budget assumptions.

At current petroleum prices the capital invested in government strategic stocks is \$10.0 billion by the U.S., \$2.3 billion by Japan, \$1.6 billion by West Germany. By 1985 the U.S. will have 450 MB valued at \$13 billion, whereas the Japanese do not appear to have firm commitments to purchase stocks beyond current levels.

#### SUMMARY

Japan's strategic stockpile program 1983 fill rate and overall size is not adequate in view of their heavy reliance on Middle East oil (50%+ of oil consumption). If the Japanese government reserve reaches 189 MB as planned, this will still only represent about 45 days of net oil imports at the 1982 import rate. Moreover, if this level is only achieved at the rate of the completion of permanent storage (i.e., by FY 1988), the implicit fill rate is only 50,000 barrels per day. In 1983 this low rate was not achieved. 1984 fill plans call for an increase to 32 days of net oil imports at the current import rate.

At the same time, the U.S. is stockpiling at far greater rates (186,000 barrels per day at present) even though we are far less dependent on oil imports. Our main concern is that Japan is not adequately buffered by its own stocks in the event of a disruption. They may not be able to meet its IEA obligations in a

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severe interruption and are likely to enter such a market bidding up prices unnecessarily as was the case in 1979. This would place the U.S. in a very awkward position of SPR drawdowns that benefit Japan without a comparable response from GOJ. The GOJ would benefit directly from any U.S. SPR drawdown since additional supplies would lower prices and free up alternate supplies for other importing countries. In effect, the U.S. is providing petroleum supply interruption insurance even though GOJ can afford its own insurance in the case of oil.

#### OPTIONS

1. Do nothing. We have raised the issue of stock building frequently with the Japanese already and they are making some progress. Raising the issue again at this time risks adding yet another area of contention to our relations with the Japanese.
2. Mount a senior level effort (Secretary, Deputy Secretary) to get GOJ to substantially increase strategic stocks in the near-term if oil markets remain calm. A high-level approach would underscore our great concern over the GOJ's relatively relaxed attitude towards stocks and our belief that adequate IEA stocks are essential to cope with any serious oil supply disruption.

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Issue

SURGE PRODUCTION - Should the U.S. undertake bilateral consultations specifically to seek increased production in the event of a disruption

Current Policy

To develop and maintain positive political, economic and security relations with certain key producer countries to demonstrate that their interests are not served by oil supply disruption. (NSDD-87, p. 9).

1. Analysis

There is presently some 10-12 million b/d surplus capacity available to meet oil supply disruptions. However, virtually none of that is in OECD countries, and over 2/3 (7 mmbd) is located in the Persian Gulf. In prior disruptions, Persian Gulf suppliers, particularly Saudi Arabia, have shown a willingness to increase production. In the event of a closure of the straits, however, most of this capacity may be unavailable.

The producers outside the Gulf with the greatest amount of spare capacity are Libya (0.9 mmbd), Nigeria and Venezuela (0.7 mmbd), and Indonesia (0.3 mmbd). All other producers combined have approximately 0.8 mmbd in available spare capacity. Given the current budget stringencies and prior practice we believe each will be inclined promptly to increase its production, charging what the market will bear. The amount of increased production will take into account both short and longer term revenue requirements. In any event, it will take several weeks to several months to increase production to full capacity and producers may also be concerned about damage to their oil fields from too rapid an increase in production or from maintaining a higher than prudent level of production. On balance, the chances are good that about 3 mmbd of additional production will be available in 30-90 days to offset shortfalls in Gulf production.

Libya is a special case, because its spare capacity is the largest outside the Gulf but also because it alone has traditionally not been characterized as a "high absorber" (i.e., a country with a large population, relatively low per capita income and pressing revenue needs). It could decide for political reasons not to increase its production --

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especially if prices rose dramatically, providing higher revenue without increasing his oil production. On the other hand, during two previous periods of tight supply (the 1973-74 Arab oil embargo and the collapse of the Shah's regime in Iran in 1979), Libya did take advantage of the market. It did this in 1973 even while it was stridently attacking U.S. Middle East policy.

The USG maintains contacts with the producer countries, and during a crisis would in any event seek information on current and projected production, along with diplomatic exchanges on the events. Because prior practice and economics would favor increased production, specific exchanges seeking an increase would be of marginal benefit. In fact, one can argue that such approaches might cause producers to make demands on us in return for their acceding or promising to accede to our wishes.

2. Recommendation:

The IESG recommends that no pre-crisis diplomatic contacts be undertaken with producer nations to seek increased production in the event of a crisis. It is likely that all OPEC producers would raise production close to maximum levels in a major disruption. Pre-crisis approaches might only expose us to political and economic demands for something which would probably happen in any case. If and when an interruption occurs, we would then consider approaches as necessary to any producer which might be reluctant to increase production to maximum levels.

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SECRETPre-Crisis Contacts to Deter Escalation  
(Information Paper)Background

Since its inception, the Iran-Iraq war has posed a threat to the security of Persian Gulf oil supplies. Iranian actions earlier in the war, combined with closure of the Syrian pipeline, have already cut Iraqi exports from 3.3 million b/d to 800,000 b/d. In the summer of 1983, Iraq moved to acquire weapons systems giving it the capability to interdict, at lower risk, Iranian exports. Iraqi use of Super-Etendard aircraft, delivered by France last fall, to launch Exocet missiles against tankers in the Gulf could keep ships from loading at Iran's Kharg Island terminal. Iraq may have the capability to damage facilities at Kharg.

Iraq has thus far not made a concerted effort to halt Iran's oil exports. Until recently, it was contemplating the possibility of resuming its own Gulf exports through a limited cease-fire with Iran. Our continuing efforts and those of others to stave off escalation in the Gulf may also have influenced Iraq to exercise restraint. However, the Iraqi Government has recently reiterated in strong terms its warning that all shipping is subject to attack in the war zone it has declared in the northern Gulf; the statement emphasized that this policy applied to tankers calling at Kharg, and reports of Iraqi attacks on tankers are increasing. Iran has responded by threatening to stop the export of all Gulf oil if its own exports are halted.

U.S. Policy

Concerned about the growing danger of a disruption in the flow of oil from the Gulf, the U.S. has undertaken several initiatives to reduce the likelihood of escalation. We have focused these efforts on convincing Iraq that alternatives to military action exist that either promise movement toward a cease-fire or would stabilize its financial position vis-a-vis Iran, permitting it to carry on the war should Iran continue to refuse to negotiate.

On the diplomatic front, we fostered UN Security Council Resolution 540 calling for a cease-fire in the Gulf, and we are urging the Secretary General to reactivate UN mediation efforts. Iran has refused to make a formal commitment even to a limited cease-fire, and we are encouraging others to explore the possibility of an informal understanding guaranteeing the security of both belligerents' oil facilities and exports in

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the Gulf. In particular, we support Japan's playing such a role.

We have urged Saudi Arabia and the other Gulf states to increase financial assistance to Iraq, either directly or by the sale of oil on Iraq's account. Our own decision to grant \$400 million in CCC credits to Iraq financed basic food imports when Iraq's need for credit was particularly acute.

We are also encouraging Iraq to develop additional oil export outlets in order to relieve financial pressures. Options currently being pursued by Iraq include a 500,000 b/d link to Saudi Arabia's Petrolina and a pipeline to the Jordanian port of Aqaba that would carry 1 to 1.5 million b/d. Even the prospect of added oil earnings would provide a basis for creditors to continue to accommodate Iraq.

Iraq has made clear that it retains, and eventually may exercise, the escalation option if international pressures on Iran have no effect. Iraq may again find itself facing a financial crisis if progress on alternate export routes is slow. Likewise, the military and psychological pressures of sustaining a war of attrition with a larger and potentially more powerful adversary may in time cause Iraq's political structure to crack. Consequently, the danger of a desperate recourse to escalation remains, and its likelihood increases in proportion to whatever success Iran may achieve in its current offensive. In pointing out to Iraq the consequences of such an action on its part, we have cautioned that an escalation of the war will not draw us into the conflict on the Iraqi side and that the direct involvement of outside powers poses unpredictable risks.

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SECRETISSUE:

Should we engage in either pre-crisis or crisis contacts with member states of the GCC and OPEC to attempt to minimize a supply disruption, and if so, on a bilateral or multilateral basis.

CURRENT POLICY:

Develop and maintain positive political, economic and security relations with key producing countries to demonstrate that their interests are not served by oil supply disruptions, to develop economic relations that reinforce the production and exchange of oil and to assist these countries, as appropriate, in their defense against outside aggression and internal unrest (NSDD-87, p.9). We have consistently avoided putting such contacts on a multilateral (p. ex., IEA-OPEC) basis.

BACKGROUND:

Last summer French Minister of External Affairs Cheysson proposed an informal producer-consumer dialogue, a call which has been picked up and echoed by Venezuela and most recently by the Swiss. The Swiss tried to sell their proposal by emphasizing that it would provide a communication channel that could be useful in a supply disruption. A Swiss official discussed the idea in early December with Yamani who allegedly was enthusiastic.

The Swiss approached us with their idea. We reacted negatively, restating opposition to formal or informal multilateral producer-consumer dialogue. The Swiss then made demarches to most IEA capitals and later reported to us that no nation was as negative as the U.S., but most countries were skeptical. In view of the negative reaction, the Swiss have informed us they intend to drop proposal.

U.K. officials have also advised us that they have heard that the Saudis might be interested in multilateral discussions focussing on energy contingency planning in the event of a Persian Gulf closure. The British are skeptical about the value of such an exercise.

On January 11, New Zealand Energy Minister W.F. Birch met with Yamani. The press release issued after the meeting noted that Birch urged a greater exchange of information between IEA and OPEC, implying a positive attitude toward a multilateral approach. Although Birch served as Chairman of the 1983 IEA Ministerial, he was given no mandate from IEA countries as a group to make such a suggestion. The USG subsequently notified our embassies that our position is unchanged.

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DISCUSSION:

We see nothing to be gained by a pre-crisis multilateral meeting with OPEC. We fear that any such discussion would inevitably lapse into a debate over pricing and production levels, both of which we consider best determined by the marketplace. Our IEA allies seem, for the main part, prepared to go along with this position.

Furthermore, we question whether there is genuine interest on the part of OPEC since statements by Yamani can be variously interpreted. We have had no direct approaches from the Saudis proposing a dialogue with consumers.

Pre-crisis discussions with individual GCC or OPEC countries would likely be more frank and open, and thus contribute to a more fruitful exchange.

The European Community meets regularly on a technical level with the GCC, and such meetings could be used, if it appears necessary, to sound out the Gulf producers on physical security issues.

The possibility of discussion during a crisis with a selective group of countries bordering the Persian Gulf should not be ruled out at this time.

Recommendation:

The IESG recommends that no multilateral contacts between oil producers and consumers be undertaken at this time. Despite tentative approaches from producers to European IEA members, we remain unclear as to what could usefully be discussed in such a dialogue. In all likelihood, we would face producer requests for price stabilization agreements which would run counter to U.S. policy. We would, however, continue a full range of bilateral contacts with oil producing states.

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